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MEMORANDUM

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NATIONAL SECURITY COUNCIL

December 30, 1981

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INFORMATION

MEMORANDUM FOR JOHN POINDEXTER

FROM: NORMAN A. BAILEY NB

SUBJECT: Preliminary Treasury Paper Involving Financial Measures Against the Polish Government and the USSR (C)

Attached (Tab I) is a preliminary Treasury paper on the subject. The other agencies participating in the Working Group are using the paper as a basis for their comments, which are due at the end of this week. The final report of the Working Group will be completed next week. (U)

In their preliminary study, Treasury draws three major conclusions:

1. A Polish default would cause problems for the international banking system but these problems would be manageable, although the Bundesbank might have to support two or three German banks. Impact on the German budget of having to make good on guaranteed loans would be substantial. (C)

2. A default of the entire Soviet Bloc would have severe and unpredictable effects on the Western banking system. Close coordination and rapid action would be required to limit damage. Even so, the panic effect might overwhelm such efforts. Budgetary impact would be substantial in several Western European countries. (C)

3. However, the likelihood of this is small. Although Romania (and Yugoslavia, not a Bloc member) would probably be forced into default, and there is some danger of this in Czechoslovakia and the GDR, there is no reason why Hungary, Bulgaria or the USSR would have to default except as a conscious political decision. Such a decision is unlikely because it would cut the whole Bloc off from external credit for the foreseeable future, rather than for a relatively limited period of time. (C)

I agree with the Treasury preliminary analysis pending comment from other agencies. (The CIA, incidentally, is doing a study of some of the possible political fallout.) (U)

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Thus, I would summarize the pros and cons of invoking the exceptional circumstances clause of the offical debt rescheduling agreement as follows:

Pro

1. We should do it because the Poles have, in fact, violated the clause. We have an unassailable justification. (C)

2. Such an action would result in the full or partial fulfillment of a series of other possible steps. It could be substituted, for example, for a partial or full trade cutoff. The banks would redline the Soviet Bloc for a period, at least, and the Soviets and their allies would have to give up real, immediate resources for what they want to buy. (C)

3. This would be very painful at present because the gold price is weak and the satellites would have to be starved of Soviet oil so that more could be sold for hard currency. (C)

4. Whatever real resources the Soviets have to give up to import grain and other things would not be available for military expenditures and foreign adventures. (C)

5. This action would preempt our allies and force private bank action simultaneously. Even if our allies did not join us in a technology/oil and gas embargo, the Soviets would simply have little with which to purchase these items. (C)

6. It might kill the Siberian pipeline. (C)

7. Domestic opposition would be disarmed and muted, since the ultimate effects would not necessarily be immediately obvious. (C)

Con

1. Ripple effects in the Western baking system would be unpredictable in any case. (C)

2. We cannot definitely say that in retaliation the entire Soviet Bloc would not repudiate its external debt, triggering a financial panic in the markets at a time when banks and thrift institutions are weak anyway. (C)

3. Preempting our allies, however well justified, will anger them. (C)

4. The budgetary impact on West Germany may be such as to exacerbate the contradictions within the governing coalition and cause its downfall. (This might be considered a pro.) (C)

5. It is an irreversible step, unlike most other action options. (C)

Allen Lenz concurs that the Treasury paper is a useful start. However, a more useful evaluation of the situation can be made after receipt and evaluation of other agency comments.

Attachment

Tab I Preliminary Treasury paper